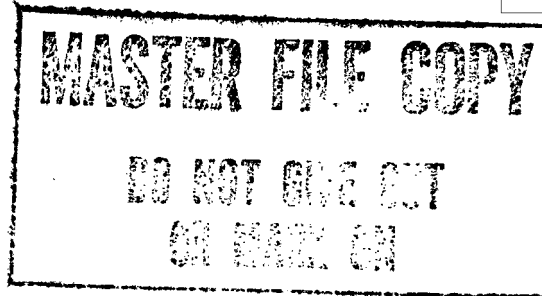




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## Inflation in Egypt: Causes and Impact

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An Intelligence Assessment

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## **Inflation in Egypt: Causes and Impact**

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**An Intelligence Assessment**

This assessment was prepared by [redacted]  
of the Office of Near East-South Asia Analysis.  
Comments and queries are welcome and may be  
addressed to the Chief, Arab-Israeli Division, NESA,

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[redacted]

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This paper has been coordinated with the National  
Intelligence Council and with the Directorate of  
Operations. [redacted]

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**Inflation in Egypt:  
Causes and Impact**

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**Key Judgments**

An extensive system of price controls and government subsidies has enabled Egypt to hold inflation to about 12 percent a year since the early 1970s. The government's willingness to bear the enormous cost of sheltering low- and middle-income consumers from inflation reflects its determination to meet popular expectations and prevent urban unrest. By intervening in this manner and by providing large wage increases, the government has helped spread the benefits of Egypt's rapid economic growth in recent years and has prevented inflation from becoming a significant source of instability.

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These policies, however, have resulted in enlarged government deficits that have been financed by rapid money supply growth. The resulting inflationary pressures have in turn made domestic controls and subsidies not only more expensive for the government to maintain but also more politically difficult for the government to remove. Further, these policies have led to greater balance-of-payments difficulties and wide distortions between controlled and uncontrolled prices. Ultimately the government will be forced to undertake major economic reforms to deal with these problems. Although Egypt's leadership is well aware of the immediate and longer term economic costs of shielding consumers from inflation, it pursues only a hesitant and gradualist approach toward reform because of concern over domestic political ramifications.

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Egypt has been able to afford subsidies and price controls in recent years because of more rapid growth, improved foreign earnings, and large aid inflows. The country now faces tighter foreign payments but can pursue several options before having to cut essential consumer imports and raise prices. The government already is borrowing from commercial sources and beginning to limit nonessential consumer imports. In the coming months it can also seek to restore aid relations with other Arab countries, curtail nonessential consumer imports more strictly, limit low-priority investment imports, or alter exchange rate policies to increase official remittance and tourist inflows. Although these options cannot be exercised without cost, they incur fewer political costs than cutting essential consumer imports.

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*Information available as of 11 June 1982  
has been used in the preparation of this report.*

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Egypt probably can delay tough austerity measures for about a year or so, but ultimately foreign payments stringencies will force the government's hand. Implementing long-overdue economic reforms almost certainly will cause prices to rise and reduce real incomes. Austerity will be unpopular, generate antiregime sentiment, and provide opponents of the regime with a readymade issue to criticize President Mubarak. If poorly handled, the imposition of austerity policies could cause urban disorders which would require the government to use force to restore order. [REDACTED]

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Massive US economic and military assistance has helped defray the cost to the Egyptian Government of controlling inflation and has allowed it simultaneously to pursue more rapid growth and to reequip its military. Egyptian leaders highly appreciate US support. They also appear wary of US pressure for economic reforms that could be politically risky. Top Egyptians, in discussions with US officials, have stated that they do not believe the United States is sufficiently sensitive to Egypt's domestic political concerns. Should Egypt's leadership come to believe the United States is pressing for economic reforms beyond those the Egyptian leadership believes are politically safe, the economic reform issue could become a major irritant in Egyptian-US relations. [REDACTED]

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### Inflation in Egypt: Causes and Impact

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#### Egypt's Subsidy System Curbs Inflation

The Government of Egypt has developed an extensive and costly system of price controls and subsidies to protect Egyptian consumers from inflation. Support for these programs derives both from an Islamic sense of social justice and from the socialist legacy of Nasir; therefore, Egyptian officials are extremely wary of tampering with them. By providing basic goods at low, controlled prices, the government fulfills its Islamic responsibility of ensuring that all Egyptians maintain at least a subsistence existence. Any reduction in government programs, moreover, would be widely viewed as cutting back on gains the average Egyptian made under Nasir.

- *Hidden subsidies* that occur when the government sells a commodity domestically—for example, petroleum—at far below world market prices.

The impact of the subsidy/price control system on prices of widely used commodities is clear:

- Bread is available in unlimited quantities and costs only 1 piaster a loaf, equivalent to 5 cents a pound.
- Sugar rations of one and two-thirds pounds per person per week cost 6 cents a pound—only one-fifth of last year's import price—and additional sugar is available at 19 cents a pound.
- Loose tea costs 9 cents a pound.
- Petroleum products sell for 7 to 77 percent of their world market prices—the average is about 20 percent of world market values.

A further overriding concern that has been expressed by Egyptian leaders to US officials is that increases in the prices of basic consumer goods could trigger violent public protests, particularly in densely populated sections of Cairo and other cities. Memories remain fresh of January 1977 when bread price hikes touched off the worst rioting since the 1952 revolution and forced the government to rescind the increases. We believe the government has no intention of allowing a repetition of this bloody episode.

Such low food prices and adequate supplies prevent the obvious malnutrition that exists in many Third World countries. Egypt's per capita caloric intake is extremely high compared to other developing countries. According to the World Bank's most recent data (which is 1977), no LDC exceeded the Egyptian per capita consumption level until its per capita GNP more than doubled Egypt's. This relatively high consumption can be directly attributed to official programs that, according to the US Agricultural Attache in Cairo, supply two-thirds of Egyptian calories.

Price controls, rationing, and subsidies designed to control the impact of inflation were started during World War II and expanded under Nasir during the 1960s. The system grew as the government sought to provide at least minimum amounts of basic commodities at affordable prices to low-income consumers. Various price controls instituted by public-sector firms and government utilities have resulted in additional subsidies. The current system includes:

- *Direct consumer subsidies* through government sales of commodities such as food or cloth below cost.
- *Producer subsidies* such as cheap electricity, low-interest loans, or other financial help for public-sector firms that produce low-cost goods for Egyptian consumers and for export.

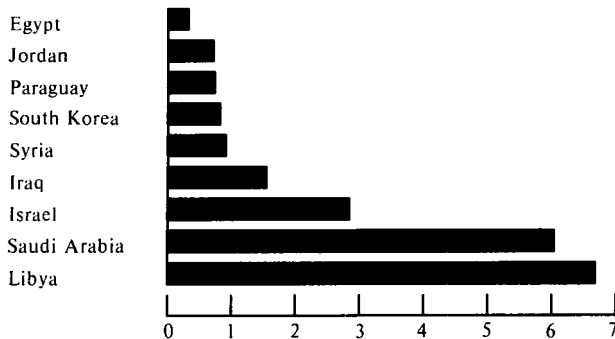
The budgetary cost of Egyptian subsidies has grown rapidly in recent years. Subsidies are essentially an open-ended spending item with the costs determined largely by import prices. Subsidies were budgeted at 2 billion Egyptian pounds (LE) for the fiscal year 1 July 1981 to 30 June 1982, but they could run 15 percent higher according to recent IMF estimates. This compares to subsidy spending of only LE 434 million as recently as 1976. Subsidy expenditures in fiscal year 1981/82 accounted for one-third of noninvestment government spending and are equivalent to

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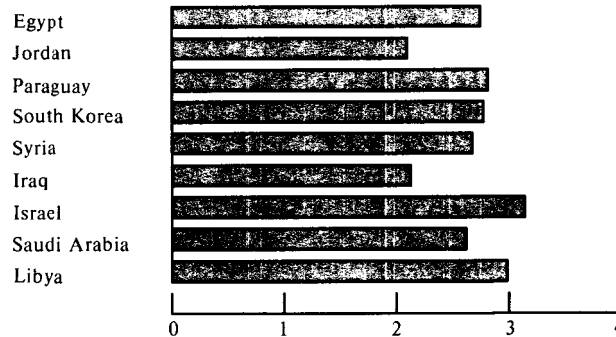
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**Confidential****Figure 1****Selected LDCs: Economic Indicators, 1977****Per Capita GNP**

Thousand US \$

**Per Capita Caloric Intake**

Thousand Calories



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13 percent of GDP. When the costs of hidden subsidies such as selling Egyptian petroleum domestically at far less than world market prices are added, the subsidy bill roughly doubles according to IMF staff estimates and is equivalent to one-fourth of GDP.

Although these costs are large, there is a further, unmeasurable cost to the economy over the longer term. Controls have greatly distorted the price signals used by consumers, producers, and investors to make decisions. Products that are relatively scarce are priced as if they were abundant. For example, low electricity rates have encouraged both private consumption and costly investments in heavy power using projects such as the aluminum complex at Nag Hammadi. The aluminum project consumes large amounts of hydropower from the Aswan dam, forcing the government to build expensive thermal power plants to meet rising electricity needs. Other examples of the hidden costs of subsidies may be cited:

- Cheap water rates have promoted wasteful urban and rural use.

- Stories frequently circulate that farmers are using subsidized bread and rice as poultry feed because of their low price.
- Low petroleum prices have resulted in consumption increases of about 15 percent a year that reduce the amount of oil available for export.
- Rent controls have discouraged housing construction.

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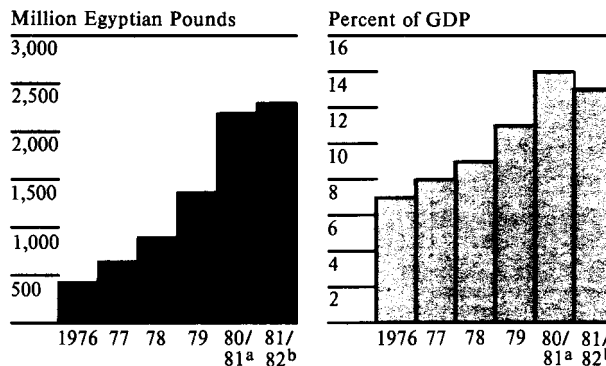
Egyptian officials have shown that they are well aware of these costs in discussions with US officials but are ambivalent. On the one hand, the subsidies and price controls are viewed as a political necessity and a direct measure of the government's support for the poor. According to Deputy Prime Minister Ibrahim, some poorer Egyptians receive as much as two-thirds of their real income through the subsidy system. Moreover, we believe that Egyptian officials expect adverse inflationary effects would occur relatively quickly once subsidies are reduced, while the

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Figure 2

## Egypt: Subsidy Spending

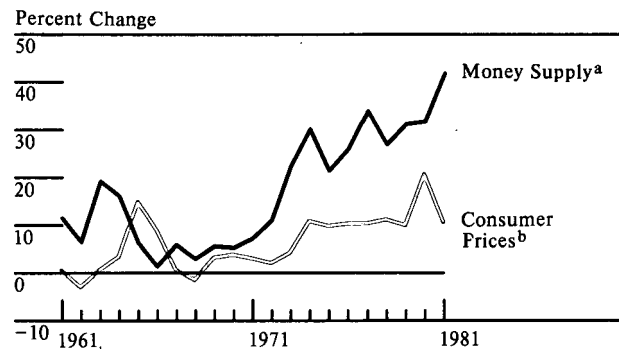


<sup>a</sup>The six-month period of January to June 1980 is excluded from this figure because Egypt changed its fiscal year from the calendar year to a July to June basis in 1980. Subsidy spending during the six-month period of January to June 1980 amounted to LE 640 million.

<sup>b</sup>IMF estimate.

Figure 3

## Egypt: Consumer Price and Money Supply Changes



<sup>a</sup>Money supply is defined as the supply of money and quasi-money as reported by Egypt to the IMF's International Financial Statistics. Increases in the money supply are calculated on a yearend to yearend basis.

<sup>b</sup>Consumer price changes are calculated on the average of the months of the year divided by the average of the months of the previous year.

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economic benefits of reform would not become apparent for some time. On the other hand, Egyptian economic officials realize that the costs are a budgetary burden that limits growth and development.

## Inflationary Trends

## The Period 1960-73

During most of the period from 1960 through 1973, Egyptians experienced minimal inflation. Prices increased at an overall average annual rate of only 3 percent. (See the appendix for a discussion of Egyptian price indexes.) Annual price increases of more than 5 percent occurred only in 1965 and 1966; in 1962 and 1968 the price level actually declined. The extraordinary increases in 1965 and 1966 stemmed from more expansionary fiscal policies and bottlenecks that developed late in the First Five-Year Plan (1960-65). The government reacted by greatly expanding its rationing of basic commodities, and this succeeded in limiting subsequent price increases.

Inflation of 3 percent a year during 1960-73 was more closely comparable to the experience in Eastern Europe than that in the rest of the Third World. During 1960-73 inflation in Eastern Europe averaged 2.4 percent annually, while inflation in the Third World averaged 15 percent a year. The similarity between Egyptian and East European inflation rates stems from the extensive use of price controls and Soviet-style economic planning and resource allocation.

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## Inflation From 1973 to the Present

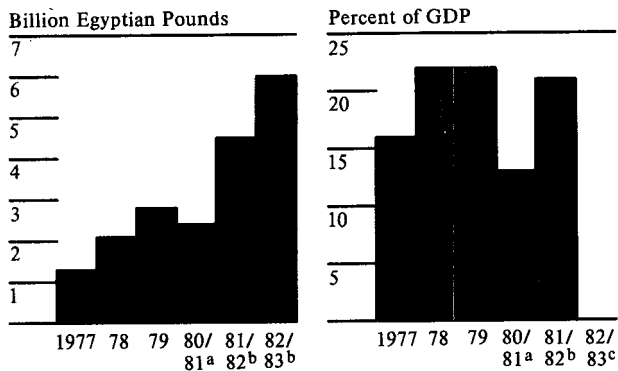
Egypt's pattern of low inflation was broken in September 1973, and since then it has averaged 12 percent a year. Heightened inflationary pressures since 1973 can be attributed to the rapid monetary expansion caused by expansionary fiscal policies. The annual money supply growth rate has exceeded 20 percent a year since 1972; in 1981 it accelerated to 42 percent. The growth in the money supply has far

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**Figure 4**  
**Egypt: Budget Deficit**



<sup>a</sup>In 1980 the government changed to a July-June fiscal year. The six-month period of January-June 1980 is not included in this figure.

<sup>b</sup>IMF estimate.

<sup>c</sup>Not available.

587202 7-82

exceeded the economy's ability to provide additional goods and services. Egypt experienced real economic growth in the range of 7 to 9 percent a year in the mid-1970s, but this additional output was far exceeded by the rapid increase in the money supply, and strong inflationary pressures occurred.

Large and rising government budget deficits were a major factor behind the rapid monetary expansion. The government has exercised little control over the deficit. Until the mid-1970s the government used an accounting system that precluded accurate fiscal measurement because of extensive double counting of expenditures. Even after the government adopted a more standard account format, it frequently has been unwilling, or unable, to provide useful budgetary estimates. For example, in the spring of 1981 then-Deputy Prime Minister Meguid presented the 1981/82 budget to the People's Assembly with exaggerated claims of a budget surplus. Meguid accomplished this by ignoring government investment

**Table 1**

**Egypt: Comparison of Controlled and Uncontrolled Prices <sup>a</sup>**

| Date          | US Embassy Price Index | Controlled Price Items in Index | Uncontrolled Price Items in Index |
|---------------|------------------------|---------------------------------|-----------------------------------|
| August 1979   | 100.0                  | 100.0                           | 100.0                             |
| December 1979 | 108.9                  | 104.8                           | 114.5                             |
| December 1980 | 128.2                  | 122.0                           | 136.4                             |
| December 1981 | 141.2                  | 126.5                           | 161.5                             |
| April 1982    | 150.4                  | 130.5                           | 177.9                             |

<sup>a</sup> Controlled price items constitute 58 percent of the overall index and uncontrolled items 42 percent.

spending and counting borrowed funds as revenues. In reality, the 1981/82 budget now has a projected deficit of at least LE 4.5 billion (\$6.4 billion), equivalent to one-fifth of GDP and one of the highest levels in the world.

Because of price controls, increases in the consumer price index since the early 1970s have been considerably less than the rapid monetary growth would suggest. With the government providing adequate supplies of basic commodities at controlled prices, low and middle class consumers are protected from the full force of inflationary pressures. These pressures instead affect goods not under price controls such as illegal rent payments, luxury goods, services, and nonsubsidized imports. Over the past 40 years, a large gap has grown between controlled and uncontrolled prices—bread is priced at 1940 levels, while imported automobiles are sold at current world prices. Using the price index devised by the US Embassy, controlled price items increased by a total of 30 percent between August 1979 and April 1982. In contrast, items not under price controls increased more than twice as rapidly. As a result, middle-income consumers can afford basic goods, but the price of better housing and expensive consumer durables is rising far beyond their means.

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**Confidential****Price-Level Fluctuations**

*In contrast to the reasonably steady year-to-year inflationary trends, month-to-month changes in price levels are more varied. Using the US Embassy price index, monthly changes have fluctuated from an increase of 6 percent in February 1980 to a decline of 3.1 percent in May 1980. In one out of every four months the price level has declined. Such variations are politically sensitive because they are a major factor in determining the public mood in Cairo and other urban areas.*

*Some of these variations are seasonal. Food prices tend to jump in March and April when seasonal vegetables are in limited supply. This period coincides with annual dust storms and increasing temperatures that heighten public irritation over the shortages before tapering off in May as increased vegetable supplies become available.*

*Government pricing policies are the other main source of near-term price instability and are politically more significant. The largest monthly price rise in recent years occurred in February 1980 when the government increased flour prices 50 percent. The sharply higher level of inflation for all of 1980 was largely the result of government price hikes early in the year. We believe these price increases were a major factor behind President Sadat's dismissal of Prime Minister Khalil and his reorganization of the cabinet in May 1980 in an attempt to shift the blame for the price hikes. Sadat imposed additional price controls in May that resulted in the downturn in prices later that month.*

**Real Incomes Rise Despite Inflation**

In recent years large pay increases to government workers have combined with price controls to enable most urban incomes to rise faster than inflation. While this judgment is based on a relatively small

sample of income data recently collected by the US AID Mission in Cairo, the data appear to be widely representative of key urban groups. Furthermore, this judgment is supported by other indicators such as rising per capita food consumption and large increases in spending on government wages. President Sadat thus was able to spread the benefits of more rapid growth and an improved foreign payments situation while containing the potentially adverse political fallout from higher inflation. 25X1

Conclusions about real income trends in Egypt previously were difficult to reach because of a lack of good data. The government does not publish data that could be used to make real income comparisons probably because it fears that opponents of the regime would use this information against it. The question of real income gains and losses, therefore, has been the subject of considerable conjecture. Leftist opponents of the regime have argued that rising inflation has hurt working Egyptians. They blame both the government and the reemergence of the private sector under Sadat's Open-Door economic policy. Housing shortages and high housing prices are also cited by these same critics as evidence that middle and lower class Egyptians are falling behind. Government officials, on the other hand, cite the rapidly growing subsidy bill and large government pay hikes as proof of successful government efforts to protect lower- and middle-income workers. For example, in the fiscal year ending 30 June 1982, the government wage bill in the budget increased by nearly 50 percent. 25X1

Data gathered by the US AID Mission in Cairo enable comparisons of recent real income gains. The data for 1978 to 1981 provide total income (wages plus nonwage payments and benefits) for workers in various employment categories for three key urban employers—the modern private sector, the civil service, and public-sector enterprises. In addition, rural wage rates collected by the government were used. After nominal income data are adjusted for inflation, several key developments stand out:

- Workers in public-sector enterprises gained more than regular civil servants.

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**Confidential****Table 2****Egypt: Changes in Real Income, 1978-81**

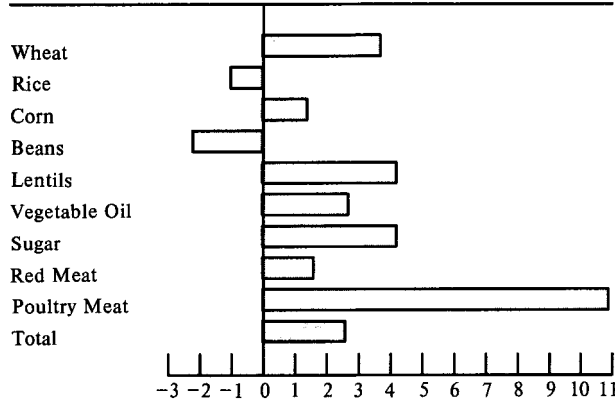
| Group/Category                               | Average Annual<br>Change in Real<br>Income, 1978-81 | Estimate of Average<br>Total Income in 1981<br>(Egyptian pounds) |
|--|---|--|
| <b>Modern private sector</b>                 |   |  |
| Managers                                     | 11.7  | 11,000   |
| Professionals                                | 3.6   | 5,000  |
| Skilled clericals                            | 2.9   | 3,900  |
| Skilled technical                            | 7.7   | 4,000  |
| Semiskilled clerical                         | 3.1   | 2,500  |
| Semiskilled technical                        | 2.6   | 2,600  |
| Unskilled                                    | -3.3  | 1,300  |
| <b>Civil service</b>                         |   |  |
| <b>Managers</b>                              |   |  |
| Undersecretary                               | -3.6  | 7,000  |
| Director general                             | -3.8  | 5,000  |
| <b>Professionals and skilled</b>             |   |  |
| Grade one                                    | 0.4   | 4,500  |
| Grade two                                    | 5.6   | 3,700  |
| Grade three                                  | 14.3  | 2,700  |
| <b>Semiskilled and unskilled</b>             |   |  |
| Grade four                                   | 23.0  | 1,700  |
| Grade five                                   | 11.7  | 1,100  |
| Grade six                                    | 7.5   | 900  |
| <b>Public-sector enterprise</b>              |   |  |
| <b>Managers</b>                              |   |  |
| Chairman                                     | 38.0  | 18,600   |
| Director or general inspector                | 19.5  | 11,300   |
| Director general                             | 14.9  | 8,100  |
| <b>Professions and skilled</b>               |   |  |
| Grade one                                    | 10.3  | 4,600  |
| Grade two                                    | 18.3  | 3,200  |
| Grade three                                  | 23.8  | 2,300  |
| <b>Semiskilled and unskilled</b>             |   |  |
| Grade four                                   | 38.9  | 1,800  |
| Grade six                                    | 33.9  | 1,300  |
| <b>Rural wages (for 1978 to 1980 period)</b> |   | <b>Average Daily Wage</b>  |
| Man  | 7.8   | 1.37   |
| Boy  | 3.5   | 0.61   |

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**Figure 5**  
**Egypt: Changes in Per Capita Consumption**  
**of Nine Basic Foods, 1977-81**

Average Annual Percent Change<sup>a</sup>

<sup>a</sup> Assumes population growth of 2.87 percent a year between 1977 and 1981. This population growth rate is from US Bureau of Census data based on adjusted data from the Egyptian census of 1976.

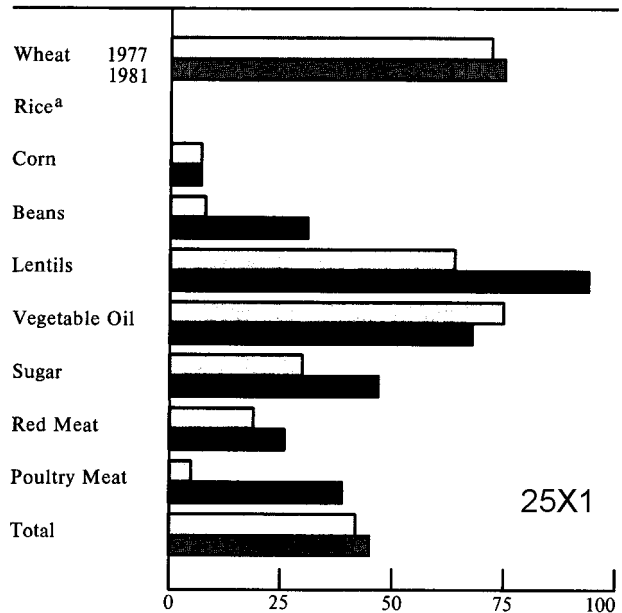
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- The greatest gains for civil servants and public-sector workers tended to accrue to semiskilled workers, although a notable exception was the sharp increases in income at the top level of public-sector enterprises largely because of increased fringe benefits.
- Increases in real incomes in the modern private sector were generally less than increases for government employees, but the overall pay level in the private sector remained higher.
- Rural wages showed steady increases over the period, probably because shortages of agricultural labor have developed as rural workers migrate to urban areas (or even out of the country) in search of higher paying jobs.

Other economic indicators also suggest that real incomes of most Egyptians have been rising in recent years. According to data compiled by the US Agricultural Attache, per capita consumption of nine basic

**Figure 6**  
**Egypt: Imports as a Share of Total**  
**Consumption of Nine Basic Foods,**  
**1977 and 1981**

Percent of Total Consumption

<sup>a</sup> No imports.

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food commodities rose annually at an average rate of 2.6 percent between 1977 and 1981. Such increases in food consumption are a good indicator of real increases in income. Poultry, wheat, and sugar consumption experienced particularly large per capita increases. This growth occurred in a country that by Third World standards already had high food consumption levels. The result of this increased food consumption is that Egypt has become even more dependent on food imports. In 1981, 45 percent of the total tonnage of the nine basic foods was imported. Three-fourths of all wheat consumed in Egypt was imported, with 45 percent of the imports coming from the United States. Large wheat imports have caused Egypt to surpass China as the third-largest importer of wheat on the world market after the USSR and Japan.

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**Confidential****Prospects**

In the coming months and years, Egypt probably will have an increasingly difficult task holding down prices as strong inflationary pressures are generated by massive budget deficits and continued rapid monetary expansion. At the same time, Cairo will have to deal with an increasingly difficult foreign payments situation as key sources of earnings grow more slowly. Despite these problems, we believe there is little likelihood that the government will abandon its policy of protecting low and middle class Egyptians from inflation through price controls and subsidies. The government probably hopes to keep increases in the official consumer price index to about 10 percent a year. Controlling consumer prices will result in larger subsidy spending that will divert an increased share of Egypt's domestic and foreign resources to consumption rather than investment and will cause slower economic growth and increased foreign payments problems. We believe the Egyptian Government considers this preferable to the potential political risks of economic reforms that raise prices. [ ]

Top Egyptian officials recently told US officials that the government does not intend to take major initiatives that would significantly limit the size of the budget deficit in the new fiscal year that started 1 July. Egypt's leaders repeatedly stressed that a gradual approach to economic reform was as far as the government was prepared to go. Instead of significant spending cuts or revenue measures, the government is planning only small changes that will barely slow the growth of the deficit. According to Egyptian officials, the new budget for fiscal year 1982/83 will include small price increases for premium gasoline, cigarettes, and utilities. Other proposed changes include eliminating ration cards for Egyptians living overseas and a new sales tax on some items. While the government points to such moves as the initial steps in its new economic reform efforts, a reversal of current budgetary trends and rapid monetary expansion is unlikely so long as major spending cuts are avoided. [ ]

The soft oil market and slower growth in other key sources of earnings have combined to tighten Egypt's foreign payments; this is unlikely to ease soon. Cairo

currently is weathering its foreign payments difficulties by borrowing from foreign commercial sources and restricting nonessential imports. As these steps prove inadequate, Egypt can pursue several options over the coming year to deal with its foreign payments difficulties before having to impose tough austerity measures that could include restricting essential consumer imports. While these options are not without cost, we believe that from the government's viewpoint they are preferable to limiting basic consumer imports. [ ]

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**Seek Additional Foreign Assistance.** Cairo could try to secure additional foreign assistance by reestablishing formal political ties and a major aid relationship with oil-rich Arab states, particularly Saudi Arabia. Ending Egypt's isolation in the Arab world would be a popular move by the Egyptian Government. Arab donor states previously were strong proponents of Egyptian economic reform, and they could press Egypt to reach an agreement with the IMF on reforms. [ ]

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**Cut Imports Further.** Egypt could conserve foreign exchange by limiting imports for lower priority investment projects and strictly curtailing consumer goods considered nonessential. Reduced investment would result in slower economic growth in the future and further deterioration in public services. Reductions in nonessential imports, particularly luxury consumer imports, would be popular among the less affluent. We believe Egypt's leadership probably will view measures against better off Egyptians as a political necessity before austerity measures are taken that affect the general public. [ ]

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**Alter Exchange Rate Policies.** Egypt could capture a much larger share of worker remittances and tourist earnings in official channels by increasing the incentive exchange rate used to purchase this foreign exchange. The current incentive exchange rate of LE 0.84 to the dollar is substantially less than the free market exchange rate of around LE 1.05 to the dollar. As a result, foreign exchange is diverted from official channels and is used for illegal imports or transferred

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to foreign exchange accounts abroad. In the past, the government has been slow to adjust the exchange rate. Central Bank and other economic officials have stated to US Embassy officials that after a devaluation the free market rate will simply climb higher and thus defeat the purpose of the devaluation. We also believe that Egyptian officials are reluctant to devalue because they fear the public will view this as an indication their policies have failed. [redacted]

Even after Egypt pursues the above options over the next year or so, it probably will still find itself short of foreign exchange and will have to impose tough austerity measures. Possible measures could include large tax increases, minimal government pay hikes, reduced subsidy spending and price hikes for basic commodities, devaluation, and sharply higher domestic energy prices. Egypt probably will have little choice but to seek an IMF loan requiring significant economic reforms. For its part, the IMF is highly critical of Egypt's failure to pursue meaningful economic reforms in the past and, according to a key IMF official involved in relations with Egypt, the IMF will require Egypt to make significant changes in domestic energy prices and raise import tariffs before the IMF approves a new loan. [redacted]

The net result of austerity will be to end the increases in real incomes that have occurred in recent years and to increase prices. This will entail major political risks for the government. Regardless of how well the public is prepared, there is a good chance that tough austerity measures, particularly any increases in basic commodity prices, will cause urban disturbances that opposition elements will attempt to exploit. We believe the government will not hesitate to use force should disorders occur, but it will face sharp domestic criticism and the credibility of its policies will be undermined. [redacted]

Criticism of economic shortcomings probably has greater appeal than any other issue for most Egyptians. Although the various leftist and Islamic opposition groups differ on how to solve Egyptian economic problems, they nonetheless find common cause in criticizing the government.<sup>1</sup> Islamic groups argue that

a return to Islamic values and traditional ways of government will transform the economy and revive traditional ways of life. Few Islamic thinkers have enunciated a practical blueprint for reform, however, and most are exceedingly vague about their vision of an Islamic Egypt. Leftist groups tend to have more highly developed notions about the shape of a future state, but are deeply divided among themselves over whether it should have a Nasirist, Communist, or even Maoist coloration. [redacted]

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Of the Islamic groups, the Muslim Brotherhood has the most potential to play a key role. Should the government face serious unrest over economic issues, the Brotherhood's attitude would be critical. If the Brotherhood came out against the regime, it has the organizational ability to generate serious domestic protests. [redacted]

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[redacted] Brotherhood members played a key role in mobilizing crowds during the bread riots in January 1977, although Sadat, to avoid a confrontation with the Islamic movement, chose to blame the leftists instead. [redacted]

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#### **Implications for the United States**

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The Egyptian Government's use of price controls to protect urban Egyptians from even higher levels of inflation has helped maintain domestic stability in a key US ally in the Middle East. Large government wage increases by Sadat spread the benefits of growth and helped further this objective. Given the potential for urban unrest that was displayed in the riots of January 1977, the government's efforts to maintain stability appear justified. [redacted]

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The Egyptian Government is keenly aware that US assistance has helped maintain government programs. The government knows that one of every three loaves of bread comes from US wheat, much of it financed by US economic assistance. In looking at the whole range of economic and military items that both the United States and the Soviet Union can supply Egypt, one outstanding US advantage is its wheat supplies. [redacted]

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Price reform is a potential area of conflict between Egypt and the United States. President Mubarak's key adviser, Usama El-Baz recently told US officials that he believes the United States and international organizations such as the IMF are pressing Cairo to make major economic reforms that will cause prices to rise. He also told US officials that there is a belief in the Egyptian Government that aid donors are not sufficiently sensitive to the situation in Egypt. We also believe the Egyptians are wary that US concerns for efficiency and more market-oriented economic policies will ultimately be linked to US aid to Egypt. The Egyptians may well believe that US economic advice is a price they must pay for large amounts of assistance; but according to such influential Egyptians as former Prime Minister Khalil, the Egyptians do not want to be pressed excessively about their domestic economic policy. Should the Egyptians conclude that future levels of US economic assistance are directly linked to policy reforms, we believe they would view this as unwarranted interference in their internal affairs. While this would not lead to anything as extreme as a break in relations, it could become a significant irritant that would weaken the entire range of relations between the United States and Egypt.

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## Appendix

### Egyptian Price Indexes

Any discussion of inflation needs to establish exactly which prices are under consideration. In the case of Egypt, there are two consumer price indexes, the official index and one compiled by the US Embassy. The official urban price index measures price changes in Cairo, Alexandria, and several smaller urban areas. The US Embassy index, started in August 1979, is based on three major markets in Cairo. Both indexes focus on low- and middle-income urban consumers since this urban majority is considered both by the government and most outside observers as the most likely source of political unrest. By concentrating on low- and middle-income consumers, both the official and the US Embassy price index probably understate inflation affecting higher income groups who spend more of their income on goods that are not under controls. These higher income Egyptians, however, are less likely to generate the type of massive unrest the regime fears most.

The US Embassy uses weights derived from the Egyptian Government's 1974-75 family budget survey. The official index uses weights from the 1964-65 family budget survey. Food accounts for slightly more than 50 percent of the hypothetical market basket in both indexes. While both of these surveys are somewhat dated, they adequately represent average urban consumers. Initial results from a new family budget survey for 1981-82 do not suggest significant changes in family spending patterns.

One particular flaw in both indexes is their failure to take adequate account of rising costs for housing. This problem exists because most rents are officially controlled, but illegal payments are common. There is no good way to measure changes in illicit rent payments or the large downpayments known as "key money" needed to secure a rent-controlled apartment. For example, the official consumer price index assigns rent a weight of 10.8 percent. During the last seven years, rent has increased by a total of only 2 percent or less than 0.3 percent a year. The US Embassy

**Table 3**

**Egypt: Comparison of Weights Used in US Embassy and GOE Official Consumer Price Indexes**

| Item                                     | GOE Urban Index | US Embassy Index |
|--|-----------------|------------------|
| <b>Food and beverages</b>                | <b>.5259</b>    | <b>.5678</b>     |
| Cereals                                  | .1123           | .1058            |
| Pulses                                   | .0662           | .0495            |
| Meats, fish, eggs                        | .1313           | .1609            |
| Oils and fats                            | .0219           | .0464            |
| Dairy products                           | .0592           | .0553            |
| Vegetables                               | .0382           | .0538            |
| Fruits                                   | .0289           | .0321            |
| Sugar and sweets                         | .0251           | .0307            |
| Beverages                                | .0428           | .0333            |
| <b>Housing</b>                           | <b>.1571</b>    | <b>.0585</b>     |
| Rent                                     | .1084           | <sup>a</sup>     |
| Fuel/electricity                         | .0352           | .0458            |
| Cleaning materials                       | .0135           | .0127            |
| <b>Furniture and durables</b>            | <b>.0132</b>    | <b>.0339</b>     |
| <b>Clothing</b>                          | <b>.0838</b>    | <b>.1369</b>     |
| <b>Transportation and communications</b> | <b>.0435</b>    | <b>.0535</b>     |
| <b>Services</b>                          | <b>.0988</b>    | <b>.0944</b>     |
| Medical care                             | .0339           | .0232            |
| Education/recreation                     | .0291           | .0444            |
| Other services                           | .0358           | .0268            |
| <b>Personal expenses</b>                 | <b>.0777</b>    | <b>.0550</b>     |
| Cigarettes/tobacco                       | .0625           | .0429            |
| Personal care                            | .0152           | .0121            |

<sup>a</sup> The US Embassy index excludes rent because an accurate method to determine changes in rents does not exist.

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index initially included rent, but it was subsequently removed because of the inability to measure changes. The static rent figures caused the overall index to rise more slowly, and this probably understated inflation.

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Table 4

**Egypt: Comparison of US Embassy and Official  
Egyptian Consumer Price Indexes,  
August 1979 to Present**

| Date        | US Embassy Index | GOE Urban Index |
|-------------|------------------|-----------------|
| <b>1979</b> |                  |                 |
| August      | 100.0            | 100.0           |
| September   | 103.1            | 100.9           |
| October     | 105.8            | 104.3           |
| November    | 107.5            | 101.9           |
| December    | 108.9            | 101.8           |
| <b>1980</b> |                  |                 |
| January     | 109.6            | 106.4           |
| February    | 116.2            | 112.7           |
| March       | 118.1            | 114.7           |
| April       | 122.7            | 118.5           |
| May         | 118.9            | 118.0           |
| June        | 121.7            | 119.6           |
| July        | 121.2            | 122.5           |
| August      | 127.6            | 121.7           |
| September   | 126.5            | 124.5           |
| October     | 131.3            | 123.5           |
| November    | 130.1            | 121.5           |
| December    | 128.2            | 122.5           |
| <b>1981</b> |                  |                 |
| January     | 129.8            | 124.8           |
| February    | 130.1            | 125.9           |
| March       | 130.7            | 127.8           |
| April       | 138.4            | 133.0           |
| May         | 137.5            | 129.3           |
| June        | 132.8            | 133.8           |
| July        | 132.1            | 132.5           |
| August      | 134.5            | 131.8           |
| September   | 136.3            | 132.8           |
| October     | 137.6            | 133.5           |
| November    | 140.6            | 135.8           |
| December    | 141.2            | 134.2           |
| <b>1982</b> |                  |                 |
| January     | 141.9            | 138.1           |
| February    | 144.7            | NA              |
| March       | 147.4            | NA              |
| April       | 150.4            | NA              |
| May         | 151.1            | NA              |

The initial reason for compiling a US Embassy index was to provide a timely source of information to monitor inflation, a potential source of social discontent. Data for the Embassy index are collected in the middle of the month and are available within days. By contrast the official index is not available for several months and thus is relatively useless as a political barometer. In addition, the US Embassy index can be divided between goods under price controls and those not under controls. This enables evaluation of the impact of changes of government price policies and provides some indication of price increases for goods not under controls.

There also was a belief that the official price index understated inflation. The US Embassy index, however, has failed to substantiate this charge. In the first few months after August 1979 the Embassy index rose much faster than the official index. Thereafter, from December 1979 to January 1982, the two indexes have moved at similar rates with the official index actually rising slightly faster than the US Embassy index. In one out of every three months since August 1979 the two indexes have moved in different directions. There has been no consistent pattern to these differences. Six times the Embassy index increased while the official index declined, and four times the reverse was true. Such differences probably occur because of the wider sample of the official index or because sampling may occur at different times of the month. The fact that the Embassy index has not differed significantly from the official index lends credence to the use of the official index for time periods prior to the institution of the Embassy scale.

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